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1. VULNERABILITY AND ACCESS TO LOW COST CREDIT

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1. INTRODUCTION

Access to low cost credit is at the crossroads of contracts, property, company and consumer laws. Thus it has many directions which may interact with the concept of vulnerability. Access to credit is critical for consumers, small and medium sized enterprises (SMEs) and large companies. Risks have been revealed through the abusive use of financing techniques such as securitisation. This has been coupled with the poor perception of the risks involved in innovative techniques of raising finance, including failure to properly explain risks to investors. This has led to increasing indebtedness and loss of investor confidence. Similar argument applies to consumers whose confidence has been affected by irresponsible lending practices that turned the subprime crisis into a global financial crisis. Lack of access to funds reveals susceptibility to loss of business for SMEs and lack of access to the housing market for consumers. The Bank of England's current interest rate (0.5 per cent)¹ has not been reflected in the interest rates of banks which have kept their interest rates at a higher level and refused to lend to businesses.²

In March 2009, the Bank of England, while reducing the interest rate to 0.5%, employed a method known as Quantitative Easing ('QE'). Essentially, QE is a monetary policy according to which the Bank of England channels credit into the economy and banks to help particularly banks to build up their reserves and to lend out borrowers. QE also enables the Government to meet the inflation target and avoids stagnation by increasing economic activity and growth. During times of financial crisis central banks may

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¹ <http://www.bankofengland.co.uk/> (last accessed 9 March 2010). The current official Bank of England interest rate was set on 5 March 2009. It is worth noting that the Bank of England rate is reviewed every month.

² P. Moores, 'Credit Strike Highlights need for reform' *Financial Times* 15 February 2009.

purchase private sector debt to assist corporate credit markets to be relieved.³ This assists companies to continue to lend and reduce the cost of credit by giving confidence to investors. However, injection of money into the economy has to stop at a certain point in order to keep the inflation target, because too much money in the market will trigger high inflation.⁴

This contribution will focus on exploring the meaning of vulnerability in the context of SMEs' access to credit. It also examines the possible effects of lack of access to finance on SMEs. The article intends to offer some various suggestions on financing the SMEs in order to overcome difficulties in access to finance through modernisation of law in this area. The recurrent theme is that, unlike most large businesses, access to low cost credit is critical for SMEs, since financiers and banks only extend credit to SMEs on a secured basis thus often apply high interest rates in which they include default risk which increases the cost of credit. SMEs that fail to access to low cost credit becomes susceptible against creditors and may be prone to insolvency. Inability to access to finance constitutes vulnerability for SMEs who need liquidity to expand their operations.

Part two will discuss briefly the background of credit crisis and reasons for lack of access to finance. In that context, the article will focus on the reasons for SMEs' difficulties in access to credit. Part three will explore the definition of vulnerability to the extent it interacts with access to low-cost credit. Part four will examine some policy issues and

³ For a recent example see '*Quantitative Easing: What is it, will it work and what are the alternatives*' The Guardian (7 October 2011) according to which the Federal Reserve purchased mortgage backed securities and corporate bonds to ease the flow of credit. .

⁴ For further information on Quantitative Easing see The Bank of England, '*Quantitative Easing Explained Putting more money in to our economy to boost spending*' available at <http://www.bankofengland.co.uk/monetarypolicy/pdf/qe-pamphlet.pdf> (last accessed on 10 March 2011). It is possible that a third round of QE may be employed. See <http://www.guardian.co.uk/business/2011/oct/09/third-round-quantitative-easing-possible> (last accessed on 10 October 2011). In the first week of February 2010, the Bank of England announced that the QE would halt as despite injection of critical amount of money into the economy, the inflation rate did not drop below 2% and the bank lending had not been affected. *The Bank of England is right to halt its injection of huge sums into the economy*, The Times, 5 February 2010. But cf. <http://www.guardian.co.uk/business/2011/oct/09/third-round-quantitative-easing-possible> (last accessed on 10 October 2011).

suggest some solutions drawn from modernisation activities of law of credit and security. Conclusions will be in part five.

2. CREDIT CRISIS AND LACK OF ACCESS TO FINANCE

The increased level of lending to borrowers with poor credit histories in the USA can be regarded as the starting point of the so-called 'credit crunch'. The credit crisis⁵ which has its roots in the subprime mortgage crisis in the USA has affected lending practices of banks after rescues and bail-outs. It is arguable that when the Glass-Steagall Act,⁶ that separated commercial and investment banks, repealed in 1999 by Gramm-Leach-Bliley Act (the Financial Modernization Act 1999),⁷ which allowed the consolidation of commercial and investment banks, the working method of investment banks (*i.e.* investment and selling bonds and equities by taking high risk) was introduced to commercial high-street banks (which only lend money on a much lower scale than the investment banks do). This arguably initiated commercial high street banks to lend under risky circumstances. Similar argument equally applies to investment banks and hedge funds which assumed debt burdens but were not regulated like high street banks. This might have contributed to the global financial crisis.⁸ Due to lack of meaningful

⁵ For a detailed analysis of credit crisis, its relationship to sub-prime mortgage crisis in the USA and suggestions for recovery *see e.g.* S. Schwarcz, 'Understanding the Subprime Financial Crisis' 60 *S. C. L. Rev.* 549 (2009) pp. 549-572; S. Schwarcz, 'Disclosure's Failure in the Subprime Mortgage Crisis' *American Law and Economics Association Annual Meetings Working Paper* no. 18, 2008; O. Bar-Gill, 'The Law, Economics and Psychology of Subprime Mortgage Contracts' 94 *Cornell L. Rev.* 1073 (2009) pp. 1073-1152.

⁶ This is officially known as The Banking Act of 1933. The Act created the Federal Deposit Insurance Corporation (FDIC) in 1933. *See also* <http://www.fdic.gov/about/learn/symbol/index.html> (Last accessed 11 March 2010).

⁷ *See* <http://www.gpo.gov/fdsys/pkg/PLAW-106publ102/pdf/PLAW-106publ102.pdf> (Last accessed 11 March 2010).

⁸ For the implications of repealing Glass-Steagall Act and an interesting background and criticism of these legislative activities *see e.g.* J. Stiglitz, 'Capitalist Fools' *Vanity Fair*, January 2009. It is important to note that recently in the USA the Obama administration has proposed breaking up of banks and limiting their overall size and functions (such as prohibiting them to deal with hedge funds, proprietary trade and private equity). *See* R. Peston, 'Obama to break up Banks' available at http://www.bbc.co.uk/blogs/thereporters/robertpeston/2010/01/obama_to_break_up_banks.html (last accessed 12 March 2010). Similar arguments equally apply in the UK. The Conservative Party banking reform paper also suggests similar solutions. *See generally* 'From Crisis to Confidence: Plan for Sound Banking' Policy White Paper (July 2009). In October 2009, the Bank of England Governor Mervyn King

regulation on investment banks and other financial institutions, the necessary capital requirements critical to shield the bank against defaults have been avoided. Normally, Basel II requirements urge banks to clarify and make transparent their supervision and legal structures in order to support credit and security.⁹ The subprime lending practices, which refer to lending to individuals (subprime borrowers)¹⁰ who pose credit risk with weak or poor credit histories,¹¹ coupled with subprime mortgage securitisations where competition among loan originators and among securitisers has played a significant role in the lead up to crisis.¹² Thus the risk involved in the lending and repayment of these borrowed amounts to financial institutions was transferred to investors who purchased securitised debts. The crisis which started as a subprime mortgage crisis turned into a global financial crisis by the globalised nature of financial markets where investors from different countries and markets purchased financial products which were the products of securitised subprime mortgages. It could be argued that the credit lent to borrowers with poor credit histories was a risky business decision. These were later on securitised as mortgage based securities to raise finance for banks. Due to the nature of securitisation,¹³

also suggested restructuring of banks in addition to regulating them. *See also* R. Peston, 'Bank of England backs "spirit of Obama's Reforms"' available at http://www.bbc.co.uk/blogs/thereporters/robertpeston/2010/01/bank_of_england_backs_spirit_o.html (last accessed 10 March 2010)

⁹ K. Alexander, 'Global Financial Standards Setting, the G10 Committees and International Economic Law' 34 *Brook. J. Int'l L.* 861, 865 *et seq.* (2009). For some criticism and suggestions for reform to financial supervision *see* G. Caprio Jr., A. Demirguc-Kunt and E.J. Kane, 'The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats' *Policy Research Working Paper 4756* (2008). It is also interesting to note that the new Basel III standards on liquidity, which require banks to hold more liquidity to be more resilient to further credit crises, are being relaxed in order to facilitate lending to consumers and businesses. *See* 'Regulators poised to soften new bank rules' *Financial Times* 6 September 2011.

¹⁰ In practice, subprime borrowers are those who FICO (Fair Isaac Corporation) scores are below 620. *See* <http://www.fico.com/en/Products/Scoring/Pages/FICO-Score.aspx> (last accessed 12 March 2010); *see also* Bar-Gill, *op cit* 5, at 1087.

¹¹ As early as 2001, FDIC released extended guidance in relation to subprime lending practices. The FDIC indicated a non-exhaustive list of credit risk characteristics posed by subprime borrowers. These include two or more 30-day delinquencies in the last 12 months, judgment, foreclosure or repossession in the last 24 months, bankruptcy in the last 5 years, relatively high default probability evidenced by credit history score and imbalanced debt service-to-income ratio. Available at <http://www.fdic.gov/news/news/press/2001/pr0901a.html> (last accessed 11 March 2010).

¹² For an interesting discussion *see* Bar-Gill, *op cit* 5, 1087 *et seq.*

¹³ Securitisation is, in fact, a simple method of raising finance based on assignment of receivables expected to be generated from future rights to payment. In securitisation receivables are collected, pooled and outright assigned to a company (SPV-Special Purpose Vehicle) specially created and bankruptcy remote from the assignor. The SPV issues securities or commercial paper to investors which are secured on the

there was lack of transparency which may be understood as the lack of information or misinformation of investors, who purchased securities from SPVs, of the structure and the risks involved in those securities.¹⁴ It is arguable that the complex nature of securitisation and various mortgage products, which have not been fully understood by investors and consumers, set the basis of vulnerability. Unreasonable risk was passed through securitisation to investors who were unaware of the risks involved. The decline of house prices and the market in the USA and defaults of borrowers with poor credit histories in repaying mortgages led to repossession of houses by banks. These risk associated elements have been arguably ignored.¹⁵ As the right to payment from risky borrowers were securitised, thus creating mortgage-based securitisation, upon maturity of securities, investors could not be repaid and they were left in a vulnerable position. The sub-prime mortgage crisis thus led to global credit crisis when banks began defaulting in their payments to each other. This prompted larger banks to restrict their lending to smaller banks, building societies, SMEs and individuals as consumers.¹⁶

It could be argued that the rating agencies were also to be blamed for the lack of transparency. One commentator succinctly explained the rating agencies involvement as follows:

receivables to raise finance in order to purchase the receivables. The originator/assignor continues to collect the receivables on behalf of the assignee. There may be an asset-backed securitisation according to which the securities created are backed by pooled assets (e.g. credit card receivables), which are collateralised and cannot be sold individually as they are so small or illiquid or mortgage-backed securitisation according to which the securities created are backed by mortgage loans, lent to mortgage borrowers (either prime or subprime borrowers). On securitisation see e.g. J.J. de Vries Robbe, *Securitization Law and Practice in the Face of the Credit Crunch* Alphen aan den Rijn: Kluwer, 2008.

¹⁴ For transparency recommendations and implementation report of International Organisation of Securities Commissions' (IOSCO) Task Force on Unregulated Financial Markets and Products see <http://www.iosco.org/> and 'Unregulated Financial Markets and Products – Final Report', *Technical Committee of the International Organization of Securities Commissions* (September 2009).

¹⁵ See generally P. Krugman, 'How did Economists get it so Wrong?' *The New York Times* September 6, 2009.

¹⁶ Arguably the Northern Rock has had difficulties in obtaining funding from larger banks post-subprime mortgage crisis due to little money available in the money markets. The BBC Business Editor Robert Peston explains this succinctly as follows: "[The Northern Rock was] much more exposed than its rivals to this distaste for mortgage debt, because its business is overwhelmingly focused on providing mortgages, rather than other kinds of banking business.' See <http://news.bbc.co.uk/1/hi/business/6994160.stm> (last accessed 12 March 2010)

reckless speculation in real estate, overly leveraged financial institutions with too little equity capital, the [abusive] securitisation of mortgages and other financial instruments with insufficient understanding of the risks involved, and many other factors all contributed to the current financial meltdown.¹⁷

It can thus be argued that there are two stages in the financial crisis. The first stage is the lead up to the credit crisis (*i.e.* risky lending decisions to people with poor credit histories). The second stage is the result of first one which caused financial institutions to severely limit their flow of credit, thus unjustly reflecting their fault on the consumers and SMEs. In other words, financial institutions are now being extra cautious to the detriment of small and medium sized borrowers. Their concerns are understandable; however, the crisis has not been caused by consumers or the SMEs. The severe limitation of access to credit arguably causes the economy of the UK to shrink.

However, there are certain matters which cause concern on both parties (banks and SMEs) to a credit transaction. These include lack of transparency and predictability in credit and security law, conservative approach to reform in security interests and lack of proper supervision on credit transactions. They, one way or the other, assist vulnerability in accessing to affordable credit.

3. DEFINING ‘VULNERABILITY’ WITHIN THE FRAMEWORK OF ACCESS TO LOW COST CREDIT

The particular point in vulnerability and access to low cost credit is defining and conceptualising the term ‘vulnerability’. The term, by itself, is multifaceted and used in diverse areas of law such as vulnerability in criminal law or vulnerability in consumer

¹⁷ T. Hurst ‘The Role of Credit Rating Agencies in the Current Worldwide Financial Crisis’ *Company Lawyer*, 61 (2009), pp. 61-64. Problems with regards to predatory lending and its effect on consumers and the role of rating agencies in subprime mortgage crisis *see* D. Reiss, ‘Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market’ 33 *Fla. St. U. L. Rev.* 985 (2006)

and contract law.¹⁸ Within the context of access to low cost credit, vulnerability may have impact on both lenders and borrowers. However, it is arguable that vulnerability may have more detrimental results on borrowers, particularly, the SMEs. This latter point merits serious consideration.

3.1 Lenders and Borrowers: Vulnerability for All

Within the context of access to low cost credit, the concept of ‘vulnerability’ can be viewed from two perspectives. Both the lenders and the borrowers are vulnerable to credit crisis and both have legitimate concerns. Firstly, lenders have vulnerable positions. Since banks borrow from each other (because the interest rate they pay to a bank is cheaper than they pay at deposit markets),¹⁹ during the credit crisis, it is argued that, they have become vulnerable due to restriction on inter-bank loans. Empirical evidence illustrated that, prior to the credit crisis, inter-bank loans were generally made to large banks and ‘too-big-to-fail considerations [reduced] the lenders’ incentives to control for borrower’s risk.’²⁰ Dinger and von Hagen argue that ‘...by generating incentives for lending banks to monitor interbank-borrowing banks, interbank exposures may also contribute to prudent market behaviour and reduce the risk of bank failures and systemic distress [as] [t]he idea is that banks are particularly good at identifying the risks of other banks.’²¹ Lenders do not wish to extend credit which may be risky. The recent credit crisis triggered lenders’ loss of confidence to the market and consumers. Their vulnerability can be explained with the volatility of the economic climate. From another angle, banks have somewhat lost their privileged position. In the UK, the so-called “rescue culture” has resulted in secured creditors’ entitlements being lost somewhat by

¹⁸ For an interesting and in-depth discussion of vulnerability, mainly from the consumer protection perspective see Consumer Affairs Victoria, ‘Discussion Paper What do we mean by ‘vulnerable’ and ‘disadvantaged’ consumers?’ (2004).

¹⁹ See V. Dinger and J. von Hagen, ‘Does Interbank Borrowing Reduce Bank Risk?’ *Governance and the Efficiency of Economic Systems Discussion Paper No. 223*, November 2007, at 7.

²⁰ See *ibid*, at 13.

²¹ See *ibid*, at 2.

recent legislation.²² This includes, for instance, the floating charge holders' inability to appoint administrative receivers. This has triggered some serious concern to banks as they prefer to be in a financially sound position in the event of debtor's insolvency. Some commentators²³ rightly suggested that the modernisation of corporate rescue legislation would result in the banks taking fixed charges²⁴ in their lending practices as opposed to floating charges in order to strengthen their positions and avoid any vulnerability in the event of the debtor's insolvency.

Secondly, from the borrowers' perspective and particularly for the SMEs affordable credit is critical for business expansion.²⁵ Without lending there is a risk that SMEs cannot be able to continue expanding their businesses. This will have wider financial impact as SMEs constitute a considerable percentage of the British industry.²⁶ Already by virtue of poor lending practices and decisions, individuals were able to borrow at extremely high percentages without due diligence and this triggered and contributed to the collapse or nationalisation of banks. The implications of these extraordinary events were felt acutely by SMEs that struggle to access to credit. The critical point in lack of access to finance is that inability to borrow reduces economic growth. According to empirical studies, clear and predictable rules that enable lenders to extend credit is said to

²² By virtue of Enterprise Act 2002, Crown preference (listed in Schedule 6 of the Insolvency Act as debts due to Inland Revenue, Security contributions and Customs and Excise) is now abolished by the Act (s.251) which provides a benefit for floating charge holders because before the Enterprise Act 2002 preferential debtors in insolvency of the debtor were used to be paid in advance of floating charge holders. On the other hand, secured creditors will lose some of their entitlements under s.252 of the Act which is inserted as s.176A of the Insolvency Act.

²³ e.g. V. Finch, 'Corporate Rescue in a World of Debt' [2008] *JBL* 756-777, at 766; D. Prentice, 'Bargaining in the Shadow of the Enterprise Act 2002' (2004) 5 *E.B.O.R.* 153, 158-9.

²⁴ However, note that *Spectrum Plus Ltd v National Westminster Bank Plc* [2005] UKHL 41; [2005] 3 *W.L.R.* 58; [2005] *B.C.C.* 694 decision refined those instances where fixed charge may be taken.

²⁵ For example, under English law, in order to be able to grant security an entity must have separate legal personality, thus ordinary partnerships, which do not have corporate personality, cannot grant security and do not have the chance to expand business as compared to private companies or limited liability partnerships (LLPs). Doctrine of corporate personality (separate legal personality) is an established concept by *Salomon v A. Salomon Co. Ltd.* [1897] *AC* 22. For a business model and legislative needs argument see J. Freedman, 'The quest for an ideal form for Small Businesses-A Misconceived Enterprise?' in *Developments in European Company Law Volume 2*, B. Rider and M. Andenas (eds) pp. 5-34 (Kluwer, The Hague, 1997)

²⁶ See *infra* note 61 and the accompanying text thereof.

positively affect economic growth.²⁷ A number of reasons for reduced lending to SMEs have been put forward. These are related to the credit crisis and its consequence on both the lenders and borrowers. The credit crisis has weakened the loan portfolios of banks which in turn caused banks to be reluctant to lend. This may be coupled with the individual problems of SMEs such as relatively low revenue or decreasing values of immovable collaterals. As SMEs do not have access to large financing options or cannot raise finance in the financial markets, unlike large companies, their credit relationships with banks, mainly based on continuous dealings or private information, have been negatively affected. Furthermore, concerns with regards to securitisation practices and made it for a certain period difficult for SMEs to enter into this type of financing patterns.²⁸

It is argued that the main problem is the risky policies of financial institutions which lent without the necessary due diligence to borrowers with weak and poor credit histories or people who have little or no creditworthiness. In order to overcome the problem of confidence to markets, in early 2009, the UK Government has announced that £600 billion would be injected to banking system in order to encourage banks to lend more into the market. The UK Government's injection of £37 billion to Royal Bank of Scotland, Lloyds TSB and HBOS in return of taking part in the management on how the banks will be run and the controls over the bonuses paid to management are critical.²⁹ It is arguable that it might be a better option for borrowers to be under the government's safety.

²⁷ R. Levine 'Finance and Growth: Theory and Evidence' *National Bureau of Economic Research, Working Paper 10766*, at 85 (2004).

²⁸ For the causes of reduced lending to small businesses see generally E.A. Duke, 'Small Business Lending' *Testimony of Ms. Elizabeth A Duke, member of the Board of Governors of the Federal Reserve System, before the Committee on Financial Services and Committee on Small Business, US House of Representatives, Washington DC, 26 February 2010*.

²⁹ 'As a condition of the deal, the government has insisted that senior directors should get no cash bonuses this year, with future bonuses to be paid in the form of shares - a move aimed at encouraging management to take a more long-term approach.' See BBC <http://news.bbc.co.uk/1/hi/business/7666570.stm> (last accessed 22 January 2010) It is arguable that investors have not lost the value of their shares as these banks have not been nationalised. The Government will also, as a result of £37 billion recapitalisation of RBS, HBOS and Lloyds TSB, through its company UK Financial Investments Ltd. exists in the management of these banks. <http://news.bbc.co.uk/1/hi/business/7706829.stm> (last accessed 22 January 2010).

3.2 Theoretical Perspectives

From a theoretical perspective, it is argued that the vulnerability of SMEs in access to credit is linked to the basic ‘freedom of contract’, ‘bargain theory’ and the law of secured credit. Banks, as secured creditors, on the basis of freedom of contract, take security and security is regarded as ‘a fair exchange for the loan.’³⁰ In a free market environment, freedom of contract is important, particularly, from the perspective of lenders who have the right to lend to those enterprises with the necessary collateral power.³¹ Freedom of contract is permitted to the extent there are overriding public policy rules.³² However, from a theoretical and contractual point of view, SMEs, just like individual consumers, do not have the sufficient bargaining power against banks and financiers. Mostly, lenders lend money based on their previous dealings with them or through business intelligence. It is arguable that between the SMEs and financiers there is an inequality of bargaining power. The ‘equality in exchange’ is absent,³³ though development of markets and possibility to trade future debts have eroded the criticalness of ‘theories of objective value and just price.’³⁴ The SMEs are too weak to bargain for credit as opposed to banks

³⁰ G. McCormack, *Secured Credit under English and American Law*, Cambridge: Cambridge University Press, 2004, at 12; for a similar argument see also P. Wood, *Law and Practice of International Finance*, London: Sweet and Maxwell, 2008, at 250.

³¹ Market order is naturally open to inequality and parties must be able to bargain on their initiative. Furthermore, inequality of bargaining power should not be cancelled otherwise, it would undermine the regime of contract, which is also the name for market. Unger argued that ‘[i]f everyone were quickly restored to a situation of equality within the market order, the method responsible for this restoration would be the true system of resource allocation. It would empty market transactions of much of their apparent significance.’ See R. M. Unger, ‘The Critical Legal Studies Movement’ 96 *Harvard L. Rev.* 561, 625-6 (1983).

³² ‘Freedom of contract’ sets the rationale in some cases that deal with floating charges which enables the debtor to raise loan capital on debentures. See e.g. *Re Brightlife Ltd.* [1987] Ch. 200 at 209. There are also other decisions that support the freedom of contract in the extension of security e.g. *Salomon v A. Salomon & Co.* [1897] AC 22 at 52; see also McCormack, *op cit* 30, at 12.

³³ The need for equality in exchange was particularly the desire of Late Scholastics who detailed rules on how contracts should be under certain types of dealings according to which the terms and conditions of a contract need to be understood by both parties and a fair price needs to be established in order to address this contract as a ‘just’ contract. Loan contracts were among those contracts that attracted the attention of late Scholastics. For further detail see e.g. J. Gordley, *The Philosophical Origins of Modern Contract Doctrine*, Oxford: Clarendon Law Series, 1991, 240 *et seq.*; M.J. Doris, ‘Did we lose the baby with the Bath Water? The Late Scholastic Contribution to the Common Law of Contracts’ 11 *Tex. Wesleyan L. Rev.* 361 (2005).

³⁴ For further information see e.g. M.J. Horwitz, ‘The Historical Foundations of Modern Contract Law’ 87 *Harv. L. Rev.* 917,946-7 (1974).

that are in a stronger position to exhort conditions in a security contract. It is also a known fact that small firms can obtain credit mostly on a secured basis, as their financial structure pose risk, which requires good credit rating and sufficient acceptable collateral as opposed to larger firms that are able to borrow on an unsecured basis.³⁵

Furthermore, SMEs' other creditors may be affected by the terms of the security contract. This is simply because it is generally accepted that when a grantor (debtor) grants a security interest to a secured creditor, other creditors of the grantor will be adversely affected as the value of the amount owed to them will be reduced. These are generally unsecured creditors or tort claimants who may not adjust the terms of their contracts particularly the interest rate they charge a borrower.³⁶

4. SOME POLICY CHOICES TO OVERCOME VULNERABILITY IN ACCESS TO LOW COST CREDIT

As mentioned, credit crisis and lack of access to affordable credit have close relationships with the concept of vulnerability. The credit crisis has had a negative impact on the flow of credit to SMEs. It is arguable that there is negative correlation between improvement of financial markets and SMEs' access to credit.³⁷

In January 2009 at the World Economic Forum in Davos and in April 2009 during G-20 Summit in London calls were made to the developed economies to create a 'Vulnerability Fund' to support developing and emerging economies and businesses thereof.³⁸ Particularly, developed economies were urged to earmark 0.7 per cent of their fiscal stimulus packages to support the programmes and efforts of the World Bank and Regional Banks. Among these programmes support for SMEs and microfinance

³⁵ See e.g. Law Commission Report No. 296 (2005), para. 1.2; M.A. Lasfer 'Debt Structure, Agency Costs and Firm's Size: An Empirical Investigation' *Working Paper* Cass Business School, at 18 (2000).

³⁶ For further information see McCormack, *op cit* 30, at 14-5.

³⁷ For a similar view see Duke, *op cit* 28.

³⁸ <http://go.worldbank.org/76E1GRKBN0> (last accessed 12 March 2010)

institutions that lend to the poor have clear significance.³⁹ Support can also be in the form of adopting international secured transactions law instruments⁴⁰ that aim to facilitate access to low cost credit and cross border trade as well as modernise domestic laws on credit and security.

SMEs are mainly financed through equity financing, trade and bank credits.⁴¹ However, factoring (outright assignment of receivables) may also be a suitable source of financing for the SMEs. One of the most significant advantages of factoring is the fact that receivables owed to SME are sold to a factoring company who may pay a discounted amount in return, rather than collateralising them (*i.e.* taking the assets as security to satisfy the claims of creditors). If the receivables are collateralised as the title stays with the SME, in the case of bankruptcy, they will become part of the bankrupt SME's estate, which means that their credit risk stays with the SME. Consequently, this is a significant element in the decision of credit supplied by the factoring company which is based on the value of the SMEs receivable rather than SMEs creditworthiness.⁴²

In Europe, 99 per cent of businesses are SMEs.⁴³ An SME is defined as an enterprise which employs less than 250 employees and has a maximum turnover of €50 million or an annual balance sheet total not exceeding €43 million.⁴⁴ The new definition of SMEs⁴⁵

³⁹ See http://comment.fco.gov.uk/roller2/debate/entry/protection_for_the_most_vulnerable1 (last accessed 30 January 2010).

⁴⁰ Such as the UN Convention on the Assignment of Receivables in International Trade and the UNCITRAL Legislative Guide on Secured Transactions.

⁴¹ See generally J. Bartholdy and C. Mateus, 'Financing of SMEs: an Asset Side Story' (2008) available at <http://69.175.2.130/~finman/Reno/Papers/sme-an-asset-side-story.pdf> (last accessed October 2011)

⁴² For the significance of factoring see generally L. Klapper, 'The Role of Factoring for Financing Small and Medium Enterprises' *World Bank Policy Research Working Paper* 3593 (2005).

⁴³ <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1003> (last accessed 22 January 2010). Also for the importance of SMEs in the EU economy see European Commission Enterprise and Industry Directorate-General Report of the Expert Group Think Small First-Considering SME interests in policy-making including the application of an "SME Test" March 2009, at 4.

⁴⁴ Extract of Article 2 of the Annex of Recommendation 2003/361EC; for the introduction of new definition of SMEs see http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/sme_user_guide.pdf (last accessed 22 January 2010).

⁴⁵ See *op cit* 44.

aims to improve access to credit by virtue of facilitation of equity financing⁴⁶ (raising finance through sale of stock to investors) in order to overcome difficulties faced with debt financing. The EU Commission observes that vulnerability of SMEs in relation to their equity position is coupled with the late payment problems.⁴⁷ However, restrictions in access to credit are faced in the early stages of the constitution of SMEs. Restrictions in access to finance through debt financing (raising finance through borrowing money) pose serious problems. One of the reasons for difficulties in access to credit is related to the contractual conditions of financiers who subject the extension of credit to guarantees or collateral which SMEs may not readily and sufficiently have at the time of their inception.⁴⁸

The SMEs also have a vulnerable equity position.⁴⁹ The EU Commission, within the framework of ‘Think Small First’ approach, has adopted in June 2008 a ‘Small Business Act’ for Europe.⁵⁰ This is, in fact, an initiative which sets out 10 principles that will guide implementation of policies throughout the EU and in individual Member States that will tackle with the problems that restrict the growth of SMEs.⁵¹ One of the principles particularly aims to ‘facilitate SMEs’ access to finance and develop a legal and business environment supportive to timely payment in commercial transactions.’⁵² Risks involved

⁴⁶ http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/sme_user_guide.pdf (last accessed 22 January 2010), at 9. It is suggested by the EU that equity financing will assist SMEs to raise finance ‘by granting favourable treatment to certain investors, such as regional funds, venture capital companies and business angels without the enterprise losing its SME status.’

⁴⁷ According to the EU Commission’s observation ‘SMEs have to wait between 20 and over 100 days on average to get their invoices paid. One out of four insolvencies is due to late payment. This leads to the loss of 450.000 jobs and of €25 billion every year.’ See *infra* note 49, at 11. In order to tackle with the problem of late payment Late Payment of Commercial Debts Regulations 2002 was adopted to amend and supplement the Late Payment of Commercial Debts (Interests) Act 1998. Furthermore, the Department for Business, Innovations and Skills introduced a Prompt Payment Code for business which encourages businesses to pay suppliers on time and provides clear guidance on payment procedures to suppliers. For further information see <http://www.promptpaymentcode.org.uk/> (last accessed 12 February 2010).

⁴⁸ It is important to note that in the UK, according to the figures of Federation of Small Businesses, every year at least 500.000 start up their own business. It can be argued that this is a significant number who may wish access to credit and failure to do so may affect the economy as a whole.

⁴⁹ Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions, “Think Small First” A “Small Business Act” for Europe {SEC (2008) 2101}, {SEC (2008) 2102}, Brussels, 25.6. 2008, COM (2008) 394 final, at 11.

⁵⁰ See generally *ibid*.

⁵¹ *ibid*, at 3.

⁵² *ibid*, at 4.

in financial crises times deter investors and financiers to invest or extend credit to SMEs. This has detrimental effect in the early stages of SMEs. The EU Commission has observed that '[p]ossible market failures in SME finance provision must be identified and corrected to further develop the European risk capital markets, to improve SMEs' access to micro-credit and mezzanine finance and to develop new products and services.'⁵³ Similar observation is also made by the Confederation of British Industry (CBI). The SME Council of the CBI has focused on encouraging government to address market failures and called for the government to provide solutions for the £250,000 to £3million equity gap facing SMEs seeking necessary capital for growth and requested the cost⁵⁴ of raising equity finance deductible for corporation tax purposes.⁵⁵

One possibility to reduce the vulnerability, particularly, in the face of financial crisis is the proposal of the European Investment Bank (EIB) according to which a certain amount of funds is to be directed to SMEs which will be mitigating their loss.⁵⁶ This may assist SMEs in accessing low-cost credit. Enterprise Finance Guarantee (EFG) is '[a] government loan guarantee scheme, delivered via participating Lenders and aimed at supporting the availability of working capital and investment funding for small and medium sized businesses in the UK.'⁵⁷ The scheme also provides security to SMEs if Lenders require early repayment of loans. The particular impact of the scheme is its facilitation of lending and thus access to credit 'by providing lenders with a Government backed guarantee for 75 per cent of the loan value'.⁵⁸ The significance of this support is two folds. Firstly, it is argued that the lender is provided with a governmental guarantee

⁵³ *ibid*, at 11.

⁵⁴ This amount is approximately £20 million. <http://www.cbi.org.uk/> Confederation of British Industry SME Council priorities (last accessed 27 February 2010).

⁵⁵ See <http://www.cbi.org.uk/> Confederation of British Industry SME Council priorities (last accessed 27 February 2010).

⁵⁶ For a similar argument <http://www.fsb.org.uk/> Federation of Small Business-European Investment Bank Proposition (last accessed 23 November 2009).

⁵⁷ <http://www.fsb.org.uk/policy/assets/efg.pdf> (last accessed 27 February 2010). For the list of participating lenders see <http://www.berr.gov.uk/whatwedo/enterprise/finance/efg/page50162.html>. Small businesses in their Principles of Small Business Banking requested that all banks dealing with small businesses should apply for European Investment Bank Credit, along with the Enterprise Finance Guarantee Scheme. See <http://www.fsb.org.uk/documents/bankingprinciples/> (last accessed 25 November 2009).

⁵⁸ <http://www.berr.gov.uk/whatwedo/enterprise/finance/efg/page37607.html> (last accessed 27 February 2010)

which aims to increase confidence that in cases of default, the Government assurance will be there. Secondly, this support aims to facilitate the borrower's access to low-cost credit which would not otherwise take place. However, recently it has become clear that banks are restricting loans to SMEs and not meeting the commitment under the government's Enterprise Finance scheme.⁵⁹ From another perspective, some economists suggest that despite the fact that SMEs cannot access to debt financing market due to lack of collateral required by banks, they can still mitigate their loss and improve their borrowing capacity by joining mutual guarantee institutions according to which the SMEs relatively pay less for credit.⁶⁰

In the UK, the Small and Medium Sized Business Federation's statistics clearly prove that SMEs are most vulnerable to credit crisis. In the UK, there are 4.7 million SMEs with 13.5 million employees and their contribution to UK economy is more than half of turnover.⁶¹ Furthermore, the SMEs in the UK suffer from unexpected changes of interest rates for loans and overdrafts, lack of access to credit despite good credit histories, differences of approach of banks in relation to access to credit, high facility fees and reverse on promised finance.⁶² Whilst this is the case in a developed economy such as the UK⁶³, in emerging markets such as the Latin American economies businesses have similar problems and they pay higher interest rates for loans with short maturities than their counterparts for instance in the USA who pay lower interest rates for loans with longer maturities.⁶⁴

⁵⁹ <http://news.bbc.co.uk/1/hi/business/8517789.stm> (last accessed 16 February 2010); *see also* <http://news.bbc.co.uk/1/hi/business/8505456.stm> (last accessed 16 February 2010); http://www.bbc.co.uk/blogs/thereporters/robertpeston/2010/02/the_acute_vulnerability_of_the.html (last accessed 16 February 2010).

⁶⁰ *See generally* F. Columba, L. Gambacorta and P.E. Mistrulli, 'Mutual Guarantee Institutions and Small Business Finance' *Bank for International Settlements (BIS) Working Papers* No. 290, October 2009.

⁶¹ <http://www.fsb.org.uk/> Report on Number Crunching the Credit Crunch (last accessed 22 November 2009)

⁶² *see ibid.*

⁶³ The UK is the 6th largest economy with 2,645,593 millions of US dollars of gross domestic product according to World Bank ranking for 2008. Information is available at <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf> (last accessed 22 November 2009)

⁶⁴ *See e.g.* H. Fleisig and N. de la Pena 'Microenterprises and Collateral' *CEAL Issue Brief* No. 2 (2002); H. Fleisig and N. De la Pena 'Peru: How Problems in the Framework of Secured Transactions Limit Access to Credit' 3 *NAFTA: L. & Bus. Rev. Am.* 33 (1997). *See also* M.A. Lasfer 'Debt Structure, Agency Costs

A supplementary approach to the EU's principles that aim to facilitate the SMEs' access to finance may be suggested. Structural and legislative changes aimed at the growth and increasing the innovative potential of SMEs within the European context can be supplemented by the innovative aspects of international instruments that aim to modernise the law of credit and security globally.

The UN Convention on the Assignment of Receivables was prepared for the purposes of establishing a model for the modernisation of domestic assignment law and as a first substantive step towards the overall harmonisation of the law of assignment of receivables in international trade.⁶⁵ The key objective of the Convention is to facilitate the cross-border flow of credit and to lower the cost of credit through harmonisation of rules that govern assignments which will lead to greater predictability and certainty in the assignment of receivables contracts.

The UNCITRAL Guide on Secured Transactions targets the modernisation of emerging markets' secured transactions legislations in which inefficient rules often prevent facilitation of secured credit as well as developed nations with inefficient secured credit laws and those with relatively efficient secured transactions regimes. Modernisation

and Firm's Size: An Empirical Investigation' *Working Paper* Cass Business School (2000), at 14. The empirical studies show that 68 per cent of small companies' debt is short-term. Only 32 per cent is payable in more than one year, while 64 per cent of the larger companies' debt is long-term.

⁶⁵ See generally Explanatory Note by the UNCITRAL Secretariat on the United Nations Convention on the Assignment of Receivables in International Trade 27 *et seq.* New York: United Nations Publications, 2004. Although the Unidroit Convention on International Factoring (the so-called Ottawa Convention 1988) precedes the UN Convention, its scope and effectiveness are far narrower than that of the UNCITRAL Convention. That is why one can argue that the UN Convention is the first truly comprehensive legislation on the assignment of receivables as it does not only affect assignments but also securitisation and project financing. For a discussion of the UN Convention, see e.g. generally S. Bazinas, 'Key Policy Issues of the United Nations Convention on the Assignment of Receivables in International Trade' 11 *Tul. J. Int'l & Comp. L.* 275 (2003); S. Bazinas, 'An International Legal Regime For Receivables Financing: UNCITRAL's Contribution', 8 *Duke J. Comp. & Int'l L.* 315 (1998); S. Bazinas, 'Lowering the Cost of Credit: the Promise in the Future UNCITRAL Convention on Assignment of Receivables in International Trade' 9 *Tul. J. Int'l & Comp. L.* 259 (2001); S. Bazinas, 'UNCITRAL's Contribution to the Unification of Receivables Financing Law: The United Nations Convention on the Assignment of Receivables in International Trade' *Unif. L. Rev.* 49 (2002); F. Ferrari, 'The UNCITRAL Draft Convention on Assignment in Receivables Financing: Applicability, General Provisions and the Conflict of Conventions', 1 *Melbourne J. Int'l L.* 1 (2001); O. Akseli, 'Contractual prohibitions on the Assignment of Receivables: An English and UN Perspective' *JBL* 630 (2009).

through adoption and implementation of the recommendations will eventually, in theory, lead to harmonisation of secured transactions regimes. For the facilitation of credit the Guide suggests that ‘secured transactions laws should be structured to enable businesses to maximize the extent to which they can utilize the value inherent in their movable assets to obtain credit.’⁶⁶ This is certainly crucial because in times of financial crisis individuals as well as businesses have no or very limited access to finance as financial institutions are reluctant to lend, possibly because of the insufficiency of protection provided by archaic property laws which often do not recognise anything but immovable and not very often, movable property as collateral. The Guide reflects clear and predictable rules as well as the practical truth that secured lending reduces the risk of non-payment and lowers the cost of credit. The Guide adopts a comprehensive and functional approach to security in order to facilitate credit according to which grantor should be able to use all of the assets and obligations and all security transactions serve the same economic purposes should be treated alike. It is argued that particularly these two significant instruments have the characteristics and effectiveness to enable SMEs to access to low cost credit and prevent their susceptibility to loss.

5. CONCLUDING REMARKS

SMEs have vulnerable position as against financiers. Credit crisis has increased their vulnerability, since access to credit has been understandably more restrictive. Under the freedom of contract perspective financiers may choose debtors, however, in the case of SMEs, particularly those of which are in the start up process, lack of necessary collateral prevents them to access to vital credit. Even when SMEs have the necessary collateral due to financiers’ loss of confidence to markets, access to credit does not seem to be possible. Although there are EU wide measures to reduce the vulnerable position of SMEs and within the UK the government’s Enterprise Guarantee scheme to increase lending to small businesses, these measures must be fully implemented. Another option

⁶⁶ Guide, para. 8, at 2.

to reduce vulnerability in accessing credit may be to adopt and implement international instruments on the law of credit and security aiming to modernise the law and increase access to low cost credit.